

# The Russian Crash of 1998

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## Preface

A while back, former Russian Prime Minister Viktor Chernomyrdin said, "We wanted to make things better, but they turned out as usual." A joke making the rounds in Moscow is that there are two scenarios for the recovery of the Russian economy: the optimistic scenario is that aliens will descend from outer space and solve the crisis; the pessimistic scenario is that it will be left to the Russians themselves. In any event, while there were some hopes at the end of 1997 that the Russian economy had turned the corner and would now begin to grow, these hopes were dashed all across 1998, as the government got deeper into debt, was unable to collect enough taxes, and finally the "flight from risk" by international investors that began in East Asia struck Russia as well, with a consequent moratorium on debt payments and a devaluation of the ruble by the government. The net result is not only no growth, but a further decline in the Russian GDP. Successive changes in prime ministers, from Chernomyrdin to Kiriyenko back to Chernomyrdin and finally to Primakov failed to solve these problems—after all, this was a powerless President Yeltsin rearranging the deck chairs on a sinking *Titanic*.

In this paper, Dr. Sergey Rogov, Director of the Institute for USA and Canada Studies of the Russian Academy of Sciences (ISKRAN), lays out the decline and fall of the Russian financial system across 1998 in great detail. At times this story is hard to follow, given all the negotiations with the IMF, IMF strictures, and attempts to get more taxes out of an economy that was at the same time demonetizing. But it was hard for the Russian government to follow as well. One is reminded of Alexander Kerensky rushing about the Winter Palace in 1917 looking for solutions, though luckily this time there are no revolutionaries outside waiting to storm the palace.

But, as the financial crash levels out, as the Russian state remains paralyzed in both collecting taxes and in paying wages, is there any Russian economy somewhere underneath that might begin to grow? In

his concluding section, Dr. Rogov lays out a series of sensible steps to stimulate and facilitate the emergence of a real Russian economy. We know on one hand that the old Soviet economy was never fully dismantled. Too many of the inefficient old state industries have tried to stay in business in what has become the largest Rust Belt the world has ever seen. Too much of the Russian population has remained on the government payroll. We know on the other hand that much of the economy has reverted to barter, mostly because of the demonetization imposed by the government in order to keep up the value of the ruble, as Dr. Rogov lays out, and partly to avoid taxes. Barter carries forward elements of the old Soviet system as well. The net effect is "the virtual economy."<sup>1</sup>

Thus, the Russian economy, financial system, and state are at rock bottom. But as the Russians say, "life goes on." People create their own economy. The survival of the fittest prevails, as in the story of the two chicken factories.<sup>2</sup> What we are unlikely to see, however, is some great growth in defense industries and production. The government doesn't have the funds, and the export market for arms is constrained, not least because of the East Asian economic depression. Even at a maximum level, however, arms sales would not rescue the Russian economy. People in business in Russia now have to sell to consumers, not the state.

The Russians have said all along, "It is up to us," though they wistfully hoped for outside help and entrée to global markets. But, as Dr. Rogov points out, it is not up to the state. The state has been found wanting. He does say that the state can facilitate the energies of the people in many ways. We on the outside will now see—but we do not have to suffer the way the Russian people will as they find their way out of their current morass.

— H. H. Gaffney

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1. Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs* (September/October 1998), pp.53-67.
  2. Sharon LaFraniere, "Capitalist Reality Comes Home to Roost in Russia," *The Washington Post*, October 26, 1998, pp. A1 and A24.

# Introduction

Both the transformation of Russia's economic and political system and the formation of its new identity after the collapse of the Soviet Union have proved painstakingly long and complex. Market mechanisms in Russia are still in their primitive stages, its financial sector is extremely weak by international standards, its industry and agriculture have been going through many years of crisis, and its scientific research potential is falling apart.

But Russia's most urgent problem is the low level of investments, without which the country's economic revival is impossible. The lack of domestic capital has not been compensated by investments from abroad. In addition, there is an ongoing capital drain from Russia. The shortage of capital investments gives little reason to believe any declarations that a long-awaited economic recovery is in prospect.

As a result, Russia, which has already found itself playing a secondary role in the world economy, could also lose its status as a military superpower over the next few years. If the current level of financing is maintained, its nuclear deterrent forces will collapse in 10 or 15 years. Its conventional forces seem to have already lost their fighting efficiency, as was evident in the Chechen war. In the next two or three years, the Russian army will have to be cut down to 12 or 15 divisions. That seems to be the maximum that the federal budget can sustain. But that level would be clearly insufficient to stage any kind of war, save for a small border conflict of low intensity.

At the same time, it is still too early to say that military forces will cease to play an important role in the next century. Of course, the military threat against Russia today is relatively low. But in a medium- or long-term perspective, this situation could change if no reliable international security system is established at the global and regional levels.

A much greater threat lies in the economic area. Russia's niche in the world market today is clearly incompatible with its economic potential. It is a country that enjoys a unique geographical situation and has the largest amount of natural resources in the world, the sixth largest population, and significant economic and technological capabilities. Yet, having rejected Soviet-style autarchy, Moscow is trying to become integrated into the world economy at a time when the Russian economy's competitiveness is extremely low.

Russia's foreign trade structure is reminiscent of that of an underdeveloped country: its exports are dominated by oil, gas and other natural resources. The share of machine building in its overall production has decreased by four times over the past five years,<sup>3</sup> and it now accounts for less than ten percent of Russian exports.<sup>4</sup>

Russia's economic vulnerability has been particularly evident during the ongoing world financial crisis. This was the first time since 1917 that we had experienced so acutely the negative consequences of interdependence with the rest of the world. Russia has appeared to be extremely vulnerable to negative shocks occurring in the world economy. The Russian market has been vulnerable to fluctuations in the world economic environment: stock prices at the Russian exchange have continued to plummet, many foreign investors have fled the country, and the bankrupt federal budget has found itself almost totally dependent on another series of loan tranches from the World Bank and the International Monetary Fund.

All of this is due to the fact that the Russian Federation is trying to become integrated into the world market at a time when conditions are against us. For instance, it is true that Moscow's accession to the World Trade Organization (WTO) will allow it not only to take part in the making of international trade rules, but also to more effectively protect Russian exporters' interests on world markets. However, we must not forget that the Russian Federation will also have to accept conditions for tariff regulations which are unfavorable to local

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3. *Finansovye Izvestiya*, 29 January 1998.

4. *Ibid.*, 13 January 1998

producers, i.e., to make substantial concessions that would allow access of foreign goods and services to the Russian market. In the negotiations on Russia's accession to the WTO in February 1998, Russia had to agree to reduce its list of strategic goods subject to high tariffs, thus increasing the items on which customs tariffs are to be unrestricted.<sup>5</sup>

Unfortunately, neither Russia's industry nor its financial sector is today in a position to compete on an equal footing with their foreign counterparts. The reduction in customs tariffs is also going to strike a further painful blow to federal income, the government having already demonstrated its ineffectiveness in collecting taxes inside the country. At the same time, Russia's accession to the WTO will complicate the recovery of the whole CIS market, since the Commonwealth countries are unable to develop a joint position concerning the decisions to be sought by them in the WTO.

It must be recognized that the important questions of Russia's economic development are currently being decided upon not by Moscow, but by the World Bank and the IMF. In the end this situation may well cause more harm to Russia than benefit.

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5. *Commerzants Daily*, 17 February 1998.



# Russia's financial troubles

## The troubles appeared early in 1998

There seemed to be some hope back in 1997 that Russia would be able to stop the disastrous breakdown of the previous years. According to official data, the year 1997 was the best in the whole decade for the Russian economy. For the first time in many years, economic decline stopped and a small growth rate was registered: GDP increased by 0.4 percent, industry by 1.9 percent, and agriculture by 0.1 percent.<sup>6</sup> In addition, the inflation rate decreased, unemployment dropped slightly, and per capita monetary income grew by a few points.<sup>7</sup> Early in 1998, Anatoly Chubais, who was then First Deputy Prime Minister, claimed that Russia's GDP would grow by 1.2 percent to 2.5 percent in 1998.<sup>8</sup>

Predictions of Russia's growth turned out to be premature, however. The Russian economy has staggered through repeated crises in 1998. One cannot exclude that the production drop signalled that the economy had entered into a period of further decline. A revival of the country's economic strength would require stable economic growth at a pace of 8 or 10 percent per year. However, as Mr. Yasin, then the Minister Without Portfolio, acknowledged, any hopes for an economic miracle in Russia in the near future would be ill-founded.

The economic crisis emerging across 1997 led to a manifold decrease in federal government revenues. The federal budget in 1997 amounted to only 60 billion dollars (at the exchange rate level). As a result, even the emergency plan of federal expenditure was not

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6. *Commerzant Daily*, 22 January 1998.

7. *Nezavisimaya Gazeta*, 31 January 1998

8. *The New York Times*, March 20, 1998.

fulfilled. The Russian government is living in a situation of permanent debt: between 1995 and 1998, the size of the internal public debt increased from 14.7 to 25.4 percent of the GDP.<sup>9</sup>

The Russian government's de facto bankruptcy has occurred because of the low amount of income tax it collected. In addition, only 62 percent of taxes are actually collected in "real money" form. Nearly half of all Russia's corporations are debt-ridden. As a result, tax debts increased by 61 percent (39 trillion rubles) in 1997, reaching a total of 104 trillion rubles.

While 90 percent of planned taxes, i.e. 593 trillion rubles, were collected in 1997 in Russia, and these revenues, as in previous years, totaled approximately 22 percent of the GDP,<sup>10</sup> the main problem lies in the fact that Russia's GDP in 1997 amounted to only 2,675 trillion rubles. This is less than 450 billion dollars according to the exchange rate, or approximately 600 billion dollars in purchasing power parity (PPP). Russia's GDP today ranks lower than 10th in the world. As a result, Russia's federal government expenditures are about 20 times less than in the US, 14 times less than Japan's, four times less than China's, etc.

It is because of this low level of economic activity that the Russian authorities lack the tax revenues to pay their bills. This has had serious consequences in the social, scientific and cultural sectors and is destroying the country's military capacity. In 1997, Russia's military expenditures dropped to three percent of GDP. Thus, Moscow today does not have the means to maintain and modernize the armed forces it inherited from the Soviet Union, and it also cannot find the funds to conduct a long-overdue military reform.

At the beginning of 1998, Russia's market economy was still underdeveloped and did not meet modern standards. According to estimates by the World Economic Forum, the Russian Federation comes 48th in

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9. *Vlast'*, No. 1, 1998, p. 37.

10. *Nezavisimaya Gazeta*, 31 January 1998. It should be noted that 22 percent represents the combined revenues of the federal and regional governments.

a list of 49 countries ordered by their degree of competitiveness. In its compilation at the end of the year 1997, the Heritage Foundation ranked Russia 102nd in a list of 158 states sorted by a so-called "index of economic freedom." Their report underlined the extreme bureaucratization, high level of corruption, widespread black market, and other weak points of the Russian economy.<sup>11</sup> On the basis of 1997's results, various international rating agencies changed their assessment of Russia from "stable" to "negative."<sup>12</sup>

Capital flight from Russia has far exceeded the sums provided as credits by international financial institutions and world financial markets. To a large extent the credits immediately leave the country through private banks working with government agencies.

Russia's current problems—depressed industrial and agricultural production, inability to collect taxes and pay salaries, etc.—are rooted in overly draconian monetarism. The ratio of money supply (M2) to GDP in Russia is the lowest in the world. In 1997, according to the Bank of Russia, it was some 14 percent. The Central Bank's rediscount rate in June of this year was 80 percent and bank loan rates in July of this year were running at about 54 percent. Money shortages are the reason why workers and taxes are not being paid and why most transactions in Russia are conducted via barter. By comparison, in the United States the ratio of M2 to GDP is about 50 percent, the rediscount rate is 5 percent, and home mortgage rates are less than 7 percent.

## **The IMF regime and the breakdown of free-market orthodoxy**

The financial and economic policy of the Russian government in the 1990s was to a very great extent driven by the advice and support of the Western international financial institutions. The International Monetary Fund (IMF) encouraged the economic policies of the Russian governments of Yegor Gaidar, Victor Chernomyrdin, and Sergey Kiriyenko. The Russian government has accepted the basic principles

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11. *Izvestiya*, 6 February 1998.

12. *Commerzant Daily*, 17 January 1998.

and advice of the IMF decision-makers. The conditions that the IMF, the World Bank, and other Western financial institutions have imposed on Moscow have contributed to the economic collapse of Russia in 1998.

According to the IMF orthodoxy, lower inflation and reduction of government expenditures would encourage investment and lead to economic growth, and, as the tax system improved, to steadily increasing state revenues. But this economic philosophy has resulted in the current chaos, and this chaos has not only led to the total collapse of the Russian economy, something unprecedented in peacetime, but is also bringing the whole world economy closer to recession.

Following the IMF prescriptions, the Russian government managed to stabilize the ruble in the first half of the 1990s. The methods used were government borrowing on the international and domestic financial markets and non-payment of government bills. The latter step led to huge wage arrears. The non-payment of wages lowered the purchasing power of the population and reduced the quantity of money in circulation. That helped to lower inflation, but it also provoked the gradual disintegration of the domestic market and a further decline in production, which in turn drastically cut the revenues of the government.

As a result, the IMF is widely criticized in Russia and abroad for giving bad advice and for lack of timely action, thus failing to head off the financial crisis. It's clear now that some of the West's mistakes in its recommendations for Russian reforms, such as its sluggishness in pushing an anti-inflation agenda and its overlooking the collapse of the real economy, could have been avoided.<sup>13</sup> Many Russian economists did not agree with the IMF prescriptions for Russia. The ruble exchange rate, for example, was set too high, making Russian goods too expensive for foreign importers, thus hurting Russian production and stalling recovery. For a long time the IMF did not insist on cuts in Russian short-term treasury bill borrowing. At the same time it demanded that Moscow solve its fiscal problems by focusing on

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13. *The Christian Science Monitor*, August 10, 1998.

raising tax revenues, while neglecting the lack of growth in the production sectors of the economy.

The IMF insisted on open markets and liberal regulations of international financial transactions. In Russian conditions, open markets and liberal regulations on international financial transactions mean not only a green light for capital flight, but also excellent prospects for the mafia. It is no accident that Russian financial markets have become one of the main centers of money-laundering for international drug dealers. But none of this has stopped the IMF and similar institutions from insisting that controls be kept loose.

Critics accuse the IMF of underestimating the impact of the Asian financial crisis on the Russian Federation. Both last fall and this spring these institutions were holding back on providing the modest stabilization support that was needed to end speculation about the imminent collapse of the ruble. The eventual IMF-led bailout in August 1998 came too late, after the situation had gotten out of control.

The 1997-1998 world financial crisis also led many in the West to admit that the IMF had made blunders. According to Henry Kissinger, "in Russia it accelerated the collapse of the economy." He wrote that:

In the name of free-market orthodoxy, it usually attempts—in an almost academic manner—to remove all at once every weakness in the economic system of the afflicted country, regardless of whether these caused the crisis or not...The inevitable result is a dramatic drop in the standard of living, exploding unemployment, and growing hardship, weakening the political institutions necessary to carry out the IMF program.<sup>14</sup>

Congressman Bernard Sanders of Vermont has written:

For the seven years since the fall of communism, the IMF has been guiding the Russian economy—to disas-

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14. *The Washington Post*, October 5, 1998.

ter... As in Mexico, Indonesia, Korea, and Thailand, the IMF has prescribed that Russia run its economy for the benefit of foreign investors and a few wealthy Russians at the expense of the Russian people. The results are clear: a few world-class billionaires, combined with economic collapse, soaring debt, mass unemployment, grinding poverty, and unpaid wages and pensions.

When communism fell, the IMF prescribed "shock therapy," essentially a Russian translation of the devastating "structural adjustment" the Fund imposed on Mexico, Africa, Southeast Asia, and much of the rest of the third world. It insisted that Russia cut government spending, sell off public assets, and raise interest rates to attract foreign investment. But as early as 1992 it was clear that this was a road to disaster: Even the World Bank, normally an IMF ally, warned that Russia's first priority should be to revive domestic production.<sup>15</sup>

## Domestic debt: the problem of GKO's

The creation of a market in Russian short-term treasury bills (called GKO's) was suggested by the US Treasury Department and the IMF as a rational way to bring Russia's financial system into the modern world. Before 1993, the Russian government had financed its budget deficit by printing money, which constantly threatened to stoke up inflation or even hyperinflation. Since then the Russian government has been engaged in very heavy borrowing instead. The government tried to use this borrowing to reduce both inflation and its budget deficit. But the "non-inflationary" methods by which most of the deficit has been financed, including emission of state bonds, has absorbed more and more of the free funds in the country.

Sales of these bonds allowed the government to lower its deficits and dampen price rises. The lenders—at first exclusively Russian financial institutions, but later including many foreign speculators—were willing to play a hazardous game of financial roulette only in exchange for big returns. To attract these funds, real annual rates of interest in the Russian bond market at times exceeded 100 per cent.

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15. *The Christian Science Monitor*, June 25, 1998.

Since the government was prepared to give lenders high returns on loans for 3 or 6 months, the lenders did not want to invest in long-term projects, where they would have to leave their money for years and have much lower returns at the end of the loan terms. So private investment in the real economy was virtually wiped out. Economic decline continued. Thus, the state actually prevented growth of private investments in the economy.

It was a vicious circle. But the problems in the GKO market are not just financial peculiarities: they are manifestations of structural faults in the real economy. Short-term state bonds were ruining investment in production. In order to maintain their value, the government and the Central Bank have had to raise interest rates on loans, thereby suppressing the real economy. At the same time, the associated tight monetary policy resulted in demonetization of the bulk of the Russian economy. Almost 75 percent of the economy was pushed to operate on barter. The Russian government and its Western supporters did not address these problems.

The GKO turned out to be a typical "financial pyramid," resembling the notorious "pyramid scheme" investment funds of the early 1990s through which many Russian citizens were stripped of their cash. The government was hooked on short-term debt. The only way it could meet the payments on its bonds was to borrow ever more money. Like a drug addict, the state was not only incapable of imagining life without borrowing, but also needed ever-greater doses of loan funds.

In 1993-1998 the government earned only 32 billion rubles of "real" money, while it had to pay 450 billion rubles for the GKOs. That means that for each ruble the government borrowed it paid 12 rubles. The domestic debt of accumulated state treasury obligations reached 700 billion rubles by May 1998.<sup>16</sup>

Servicing the domestic debt in 1996 had already exceeded 20 percent of the expenditures of the federal budget. The servicing of the public debt in the budget for the 1998 fiscal year was supposed to take approximately 24.1 percent of all planned federal expenditures.<sup>17</sup>

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16. *Finansovye Izvestiya*, June 6, 1998.

However, by February 1998 the Ministry of Finance recognized that the costs of servicing the national debt in the current year would take almost 100 billion rubles instead of the 82.6 billion rubles stipulated in the proposed budget bill. Later on Boris Nemtsov admitted that one-third of the budget was spent on servicing the state debt.<sup>18</sup> Repayment of the GKO treasury bills alone would consume 70 percent of the federal budget by the year 2000 if the market kept growing at the same rate.<sup>19</sup>

Sergey Kiriyenko, who became Prime Minister in the spring of 1998, recognized that the government's revenues were short some 4 billion rubles each month. By July 1998, he revealed that Russia had already paid 36 percent of its budget for the year to redeem its securities. He said that the government had to pay off 31 billion rubles every month, or one-and-a-half times more than it was collecting in monthly revenues.<sup>20</sup>

The government had to borrow more staggering sums at mounting interest rates each week in order to pay off earlier debts. It found itself in a very difficult situation given the swiftly accelerating nature of Russia's financial crisis. Debt service was now 2.5 times higher than tax revenues and it was growing at 30 percent per annum. Inevitably, the point came where there was simply no money in the budget to continue servicing the debt.

The Russian government thus plunged into permanent debt: from 1995 to 1997 the state internal debt grew from 14.7 percent to 25.4 percent of the GDP.<sup>21</sup> By the summer of 1998 it reached, according to Kiriyenko, 44 percent of the GDP.<sup>22</sup> Only a month before that, he had put the debt at less than one-third of the GDP. The percentage of

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17. *Finansovye Izvestiya*, 27 January 1998.

18. *Interfax*, July 7, 1998.

19. *Business Central Europe*, July/August 1998, p.21.

20. RFE/RL, July 2, 1998.

21. *Vlast*, No. 1, 1998, p. 37.

22. *The Los Angeles Times*, July 11, 1998.



debt rose sharply in part because Russia had to borrow at higher and higher interest rates to retire maturing treasury bills.

As a result, Russian government expenditures that were not tied to debt payment dropped from 25 percent of the GDP in 1992 to less than 10 percent in 1998.<sup>23</sup> The government draft budget for 1999, as prepared in the summer of 1998, set 164 billion rubles to pay its debts, which meant that 46 percent of the revenues would be used for debt servicing.<sup>24</sup> Kiriyenko wanted to finance the debt with foreign credits of 3.1 billion rubles and domestic borrowing of 61 billion rubles. The expected revenues were supposed to reach 12.97 percent of the GDP, while expenditures were planned at 15.7 percent.<sup>25</sup> The government wanted to reduce by half the federal transfers to the regions, that is, from 51.7 billion rubles in 1998 to 26.8 billion rubles in 1999.<sup>26</sup>

As the *Boston Globe* remarked, "within a decade, Russia has gone from being a superpower that bestowed weapons and credit on tinpot dictators to being an incorrigible deadbeat borrower."<sup>27</sup> Russia's state debt amounts to about \$200 billion, which equals 3 or 4 yearly federal budgets, as Russian Deputy Prime Minister Nemtsov noted in July 1998.<sup>28</sup>

A great deal of the blame lies with the IMF. Not only did the IMF encourage the Russian leaders in the illusion that squashing inflation would automatically lead to growth, but the IMF also fed the misconception that if things went wrong, there would be plenty of money in the world financial system to bail the Russian government out.

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23. *Nezavisimaya Gazeta*, June 26, 1998.

24. *Kommersant Daily*, July 18, 1998.

25. *Kommersant Daily*, August 11, 1998.

26. *Ibid.*

27. *The Boston Globe*, July 10, 1998.

28. *Interfax*, July 7, 1998.

## Russia's foreign debt

The burden of Russia's accumulated foreign debt, the service of which consumed about one-third of the annual federal budget, was already making itself felt by the end of 1997. The foreign debt has continued to grow across 1998. At the end of 1997, Russia had to start repaying \$3 billion to the members of the London Club (non-government creditors), as required by the conditions of the 25-year scheme for the restructuring of the Soviet Union's foreign debt (\$32 billion, including \$24 billion forming the core of the debt and the rest in interest). And to honor its agreements with the Paris Club (government creditors), Russia is going to have to pay at least \$4 billion per year in interest during the postponement period and \$12 billion per year after that.<sup>29</sup> These debt payments have to be made despite the outflowing tide of capital caused by the large numbers of foreign investors leaving the Russian market.

Since 1995, revenue from foreign sources has covered more than 50 percent of the federal deficit.<sup>30</sup> On January 1, 1998, the total amount of short-term foreign debts of Russia was \$33 billion. The foreign debt accounted for 16 percent of the general debt. Two thirds of this debt—14.4 percent of GDP—are related to GKO's purchased by foreigners. The required payment of interest is only about 2.9 percent of GDP, but Russia also needs to pay off Eurobonds and other external credits. The payment of interest on external debts in 1998 was supposed to take \$7 billion, that is, 1.3 percent of GDP.

By far the largest part of Russia's \$158 billion foreign debt consists of the debt owed to foreign creditors by the former Soviet Union, for which the Russian Federation agreed to accept responsibility back in 1991. Together with interest the Soviet debt exceeds \$91 billion.<sup>31</sup> Russia also inherited the debts of 50 foreign countries to the USSR. These countries owe an estimated \$165 billion to Russia. But most of the former Soviet clients in the Third World are not able to pay their

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29. *Izvestiya*, 3 December 1997.

30. *Russian Statistical Annual*, p. 418.

31. *The New York Times*, September 25, 1998.

debts to Moscow. In 1992-1997 the Russian Federation was able to get from them only \$24.6 billion, an average of only \$4.1 billion a year,<sup>32</sup> so their payments could not offset the debt burden that Russia had to carry.

The second largest component of Russia's foreign debt is loans from international financial organizations, primarily the IMF, repayment of which begins in 1998 and extends over 17 years. Loans from foreign governments are repayable over 8-10 years and commercial loans are repayable over 5-10 years. By the beginning of 1998, Russia was the third largest borrower from the IMF after South Korea and Indonesia.<sup>33</sup>

In 1997, the Russian government struck debt-restructuring deals with the London and Paris Clubs of creditors. The debt, amounting to almost \$70 billion, will mature only in 2015 and 2020. It is to be repaid over a period of 25 years, starting in the year 2003. Moreover, agreements with the London and Paris Clubs envisage that only one-sixth of the outstanding (post-Soviet) debts will fall due before the year 2002.

According to the analysis of the Russian-European Center for Economic Policy, in the absence of debt rescheduling Russia would have had to repay foreign creditors \$18.1 billion in 1997. Rescheduling allowed Russia to limit its repayments to \$7.1 billion, which was more than offset by \$8.5 billion in new loans.

Thus, Moscow is paying back old debts with one hand while accumulating more and more debts with the other. The Russian Federation has turned into a sort of "financial drug addict," becoming more and more dependent on foreign credits. Where will it bring the country to by the next decade, at a time when the hopes were that the national economy would start gaining momentum?

Some economists claimed that the potentially huge size of Russia's economy and the long maturity period of most foreign debt would

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32. *Finansovye Izvestiya*, June 16, 1998.

33. *Nezavisimaya Gazeta*, June 6, 1998.

allow Russia to easily meet its obligations. But that was incorrect. Russia's external debt had jumped by 1998 to almost 50 percent of its GDP, as compared to 39 percent for other emerging markets like Brazil and Argentina. The average ratio of hard currency reserves to GDP in the world is about 8 percent (in China it's 15 percent), but in Russia it dropped to less than 3 percent.<sup>34</sup>

In the absence of substantial new loans, the big crunch was to be expected 4 to 5 years hence, when deferred repayments on post-Soviet loans start to fall due, closely followed by the beginning of repayments on the huge Soviet-era debt. But the crunch came much earlier. The immediate problem was too large a short-term government debt in comparison with international reserves.

Even up to the last moment before the crash of August 17, 1998, some experts believed that Moscow could have addressed its debt squeeze through borrowing from private banks, but that it strongly preferred IMF financing, which would be made available on much more favorable terms. Thus the crisis was both overstated and misdiagnosed by the Russian government and its benefactors in Washington alike in order to promote a preference for IMF assistance.<sup>35</sup>

Russia's short-term debt in GKO's of about \$70 billion had been an immediate concern because of their extraordinarily high interest rates. These rates had soared because of declining investor confidence in Russia and the government's desire to stem the resulting outflow of capital.

For the rest of 1998, Russia's debt payments total almost \$30 billion. The critical issue is about \$25 billion of GKO's held by Russian commercial banks and foreign investors.<sup>36</sup>

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34. *NG-Politekonomiya*, June 1998.

35. "The Russian Crisis: Implications for U.S. Policy," A Presentation by Nixon Center President Dmitri K. Simes, the Nixon Center, Washington, DC, July 22, 1998.

36. *The Moscow Times*, July 7, 1998.

## The crash of the Russian stock market

Until late 1997 and early 1998, the Russian Government thought it was immune to spillover from the Asian crisis. However, during 1998, Russia's foreign currency market came under unprecedented attack from both foreign and Russian speculators. Russia's stock market, barely four years old, rose 97.7 percent in 1997 after soaring 141.8 percent in 1996.<sup>37</sup> The government securities market ballooned from \$17 billion to over \$70 billion.<sup>38</sup>

But Russia quickly lost its leading position as one of the highest-profit financial markets in the world. As quickly as it inflated, the bubble burst. The government's reckless issuance of short-term domestic debt produced a crisis of investor confidence when Russia was struck by Asia's financial turmoil. The first attack on the ruble took place in October-December 1997, the second attack took place in February 1998, and the third attack took place in the third quarter of 1998. More than \$40 billion of nominal capitalization of Russian companies has been wiped out in the 70 percent drop of the Moscow stock market since its peak.<sup>39</sup> In the summer of 1998 the index of the most popular Russian shares fell by 90 percent. Volume has trickled down to almost nothing. Russia's commercial stock market has collapsed.

Since the beginning of the crisis, non-residents had been withdrawing \$3 billion a month from Russia. In the period November 1997-March 1998, \$18 billion left Russia, including \$10 billion that had been the proceeds from redeeming state treasury obligations. In April 1998 the new wave of capital flight began as state bonds worth \$20 billion reached their maturity.<sup>40</sup> Russia faced the prospect of a complete collapse of its currency if foreign investors, who held about \$20 billion of Russian debt, began selling rubles.

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37. *Boston Globe*, July 5, 1998.

38. *Business Central Europe*, July/August 1998, p.21.

39. *EIR*, July 3, 1998.

40. *Finansovye Izvestiya*, June 11, 1998.

## The solvency of the Russian state came into question

The preeminent feature of the financial crisis in Russia, however, was that the very solvency of the state was in question. The Central Bank was battling to support the ruble in the face of the crisis in the financial market. It was losing several hundred million dollars of hard currency reserves every day in an attempt to preserve the value of the ruble. Thus, the discount rates, extraordinarily high compared to a relatively low inflation rate (less than 2 percent per month), sent the interest rates of state short-term state treasury obligations to a peak of 150 percent. The Russian government thus drove itself into a budgetary and currency morass. As a result of the rise in GKO interest rates, the prices of domestic loans soared, making a further aggravation of the budget crisis inevitable.

The Central Bank of the Russian Federation has become the major buyer of the GKOs. In 1997 its portfolio of securities grew from 75 to 160 billion rubles, which means that it bought them for \$14.5 billion. GKOs accounted for 27 percent of the assets of the Central Bank on January 1, 1997, but 47 percent a year later. Thus the Central Bank financed about a half of the federal budget deficit.<sup>41</sup>

But by the fall of 1998, Central Bank reserves had dwindled from \$24 billion in the middle of 1997 to about \$13 billion, including gold, as the government struggled to meet more than \$1 billion a week in debt payments.

Thus, the government of Russia found itself in a budget-currency squeeze. The growth in the yield of the GKOs raised the price for internal loans and made a new deepening of the budget crisis inevitable. First of all, non-residents have been removing their money from the state obligations market. The need to maintain this market demanded an increase in the yield of the GKOs, increasing the costs of servicing the internal debt.

The most alarming thing was that the pyramid of short-term state bond debt was stifling the real economy, insatiably requiring the pay-

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41. *Finansovye Izvestiya*, July 2, 1998.

ment of prohibitive rates of interest. Some 31-32 billion rubles a month were already being paid out—50 percent more than had been planned in the budget. Total repayments of short-term state bond debts in 1998 required 378.2 billion rubles. Feeding the “short-term state bond monster” demanded 36.2 percent of budget expenditures instead of the 25 percent that had been planned. Meanwhile the government was collecting only about 20 billion rubles a month. In other words, short-term state bonds are consuming money that could have been used to solve the pay problems of scientists, miners, and the military.<sup>42</sup>

Russia is in a rampant financial crisis. Three-month treasury bills issued at 100 percent interest in June 1998 to gather enough money to pay off older obligations were to mature in the autumn and send the debt level soaring even higher. At a rate above 120 percent, selling ruble-denominated treasury bills and bonds could no longer be an option for the government. Monthly spending for the maintenance of the bonded debt pyramid (interest, and redemptions when necessary) already exceeded monthly budget revenue.

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42. *Rossiyskaya Gazeta*, July 2, 1998.

## The financial crash of 1998

By the autumn of 1998, meeting both domestic and foreign debt payments was clearly unsustainable. The ensuing turbulence threatened to undermine the country's entire public finance system, devour the Central Bank's hard currency reserves, and force a catastrophic devaluation of the ruble. Fears spread that a collapsing currency would devastate the banking system, spark renewed inflation, and destroy what little faith the Russian people retained in the competence of their government. Panicked Russian and foreign investors have been scurrying to pull their rubles out of tumbling markets and trade them for more stable dollars, and this has drained Russia's hard-currency reserves.<sup>43</sup>

Russia's GKO market had melted down in July. To sell its GKO's, the government was forced to increase interest rates to over 150 percent. The government also had to delay the sale of a 75 percent stake in the oil company RAO Rosneft, after the main bidders, including the Royal Dutch Shell Group and British Petroleum, said they wouldn't participate in the tender.<sup>44</sup>

Russian Finance Minister Mikhail Zadornov conceded that Moscow had made a mistake by relying too much in the past on the issuance of GKO's to finance its budget deficit. He noted that the share of debt service as a proportion of budget expenditures had risen from 2 percent in the first quarter of 1994 to 33 percent in the middle of 1998. "The previous strategy was clearly a mistake," Zadornov said, adding that he saw a "way out" by restructuring Russian debts into longer-term instruments.<sup>45</sup>

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43. *Los Angeles Times*, July 11, 1998.

44. *Izvestiya*, July 30, 1998.

45. *Reuters*, July 27, 1998.



With those diminishing resources, the Kiriyenko government, in office only since April 24 of this year, decided to defend the ruble at all costs. In a gloomy report, the Prime Minister warned Parliament that social tension was rising in Russia and that financial markets had "practically ceased to exist." In his address to the Federation Council, Kiriyenko also said the government's proposed new economic program to overhaul tax laws and cut spending represented a wholesale change in economic policy. He said in his speech, "Social tension is growing in society, which naturally is not helpful to stabilization." The Prime Minister—a former banker—dug in his heels, however, when asked if the ruble would be devalued. "Never," he said.<sup>46</sup>

"We are willing to consider any proposal, but we simply cannot fail to repay treasury bills," Kiriyenko told lawmakers who had urged the government to divert some of the debt-servicing funds to pay overdue wages to restless workers and impoverished retirees.<sup>47</sup> To restore confidence, it was proposed that Russia get some kind of stabilization credit to replenish international reserves to a level of \$20 billion to \$25 billion.

## The attempted bailout of mid-1998

Anatoly Chubais was brought back to the government and appointed by President Yeltsin as the special negotiator with the IMF and the World Bank to arrange a huge bailout, no matter what the conditions. The IMF and the World Bank claimed that the implementation of their conditions would lay the basis for sustained economic growth and social recovery in Russia. Thus the crucial questions of Russia's economic development were to be decided upon not by Moscow, but by the World Bank and the IMF. In the long run, this situation may well cause more harm to Russia than benefit.

The new loans pledged to Russia by the International Monetary Fund and the World Bank came with several conditions, including lowering the crippling budget deficit, overhauling the tax system and

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46. *Associated Press*, July 10, 1998.

47. *Los Angeles Times*, July 11, 1998.

improving conditions for investors. But a quick look over the past few years shows Russia has never fully complied with all of the conditions of past IMF loans.

As some of the conditions, the IMF insisted that Moscow reduce financial support to the regions and decrease import duties from 30 percent to 20 percent. This kind of openness of the Russian market could have resulted in a crash of many noncompetitive Russian manufacturers.

Even IMF officials admitted the dubious character of the bailout request and expressed concern that the new IMF loans would drain resources. "We could manage an amount of assistance to Russia with the facilities that are currently available to us, but it would not be easy and it would make the situation thereafter very difficult,"<sup>48</sup> said John Odling-Smee, head of the IMF division dealing with the former Soviet republics.

That is when the international financial organizations intervened. Under pressure from the Clinton Administration, the IMF and the World Bank come through with a debt-restructuring package. The White House decision to publicly nudge the IMF and the World Bank was unusual. U.S. officials have a major voice in the lenders' decisions and historically have exercised influence from the inside. But this issue is viewed with great concern in Washington because the collapse of the ruble could send the Russian economy into a tailspin.

The US administration appeared particularly desperate in its efforts to help the Russian government get through its financial crisis since President Bill Clinton was due to visit Moscow on September 1. David Lipton, the Undersecretary for International Affairs at the US Treasury, flew on August 15 to Russia and held talks in Moscow with Kiriyenko to discuss the government's financial plight.

"Our interest in successful political and economic reform in Russia is compelling," U.S. Treasury Secretary Robert Rubin wrote in a letter to Newt Gingrich, the Republican Speaker of the House of

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48. *Reuters*, June 9, 1998.

Representatives. "A collapse of the ruble would undoubtedly strengthen Russian opponents of reform, who include ultra-nationalists and Communists as well as the oligarchs who want to protect their special interests." He said a non-reformist Russia could be more likely to oppose U.S. foreign policy interests. The crisis in Russia could spread across central and eastern Europe, and economic or political troubles there could hurt U.S. firms and workers, he added. "This is the wrong time for the IMF to withdraw from this strategically important country," Rubin said. "We have a significant opportunity to use the leverage of IMF financing to help the Russian government finally take the myriad steps needed to put its finances on a sustainable path."<sup>49</sup> Later he praised Russia's reformist government and said Russia had made progress, although he admitted problems lay ahead. He noted that, "The government of Russia today is by all measures the best government they have had since the Soviet Union collapsed in terms of focusing on reforms."<sup>50</sup>

On the other hand, some people in Washington argued that "the United States neither can nor should do anything more to aid Russia but instead should reconstruct a firewall around this basket case of a country and try once again to contain the Russian threat to markets and democracy around the world."<sup>51</sup>

However, the US Treasury pushed the IMF into rapidly concluding a massive package of financial support. The governments of other industrialized countries have also got the message from Washington. It's therefore no coincidence that the Japanese Government's aid package has become the second step in the stabilization of the Russian financial system. The new foreign loans have been designed to calm the stock and bond markets, stave off a devaluation of the Russian currency and restore confidence among investors who have been fleeing the country.

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49. *Reuters*, August 4, 1998.

50. *Reuters*, July 30, 1998,

51. *The Washington Post*, September 21, 1998.

The IMF announced that it was to lend an additional \$11.2 billion to Russia in 1998, plus \$2.6 billion in 1999. When existing loan agreements were included, the IMF, World Bank and the Japanese government were prepared to extend \$17.1 billion in new loans to Russia over the next two years, thus making \$22.6 billion available to Russia by the end of 1999. That is equivalent to some 5 percent of the country's annual GDP.<sup>52</sup>

But the new rescue package reduced the overall IMF reserves to about \$13 billion. Given the size of the additional financing, and the IMF's liquidity position, the IMF decided to activate its reserve, the "General Arrangements to Borrow" (GAB) to secure most of this additional financing for Russia. That made it urgent for the U.S. Congress to act promptly on President Clinton's request for a new \$18-billion line of credit for the IMF.<sup>53</sup>

Half the amount for 1998 (about \$5.6 billion) was to be provided as soon as the agreed actions of the Russian government had been taken, by legislation where necessary, and upon IMF Executive Board approval. The rest would be made available during the remainder of the year. Together with the resources provided under the current IMF Extended Financing Facility (EFF) credit for Russia, total financing from the IMF during the remainder of 1998 would amount to about \$12.5 billion.

The Russian government requested a new EFF for the years 1999-2001. Further IMF financial support for Russia's medium-term economic program on a scale to similar to that of the present EFF will reach about \$2.6 billion per year.

The World Bank also reached an agreement with the Russian government on a far-reaching structural reform program, and thus decided to make available an additional \$800 million in 1998. Together with disbursement of already committed adjustment loans, total adjustment loan disbursements by the World Bank to Russia during the remainder of 1998 would then amount to \$1.25 billion.

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52. *Financial Times*, July 15, 1998.

53. *Los Angeles Times*, July 15, 1998.

The World Bank planned a total disbursement of some \$3 billion in adjustment lending for Russia in 1999, subject to strong progress in the reform program and to approval by the Bank's Board of Executive Directors. Total World Bank disbursements to Russia during the remainder of 1998 and 1999, including adjustment and investment lending, could reach up to \$6 billion.

During the same period, as previously announced, the Japanese authorities plan to provide \$1.5 billion in balance of payments support, co-financed with World Bank adjustment loans.

The White House endorsed the IMF decision: "The United States commends the important steps Russia has taken to strengthen its public finances, preserve financial stability and further help lay the groundwork for economic growth through structural reform," it said. The White House spokesman said, "We welcome the decision by the IMF executive board to expand its funding for Russia's reform program. We look forward to full implementation of these reforms and to additional action to put Russia's finances on a sustainable path."<sup>54</sup>

## Reflections on the bailout proposal

There are plenty of reasons to wonder why the IMF chose this moment to extend another loan to Moscow. Its resources were already strained from a series of multi-billion dollar bailouts for ailing economic tigers in Asia, and Moscow is in some ways not an ideal borrower.

The last time the fund extended a helping hand was in the summer of 1996, and most commentators agreed then that its offer of an EFF worth \$10.2 billion was more or less a contribution to Boris Yeltsin's flagging re-election campaign. The IMF may then have helped banish the specter of financial crisis from a wide swath of Europe. But it is by no means certain that the billions of dollars now being extended to Russia by the IMF, the World Bank, and the Japanese government will help eliminate the problems that created the need for the bailout in the first place.

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54. *Associated Press (Washington)*, July 20, 1998.

The IMF's actions since the granting of the EFF package in the summer of 1996 seem to have taught the Russian government that it was not necessary to implement wide-ranging reforms in order to receive loans from the IMF. The fund has repeatedly—in October and November of 1996, in January–March and October of 1997 and in May–June of 1998—postponed disbursement of tranches from the EFF, usually on the grounds of lackluster tax collection. But it has generally shelled out once Moscow loudly proclaimed its commitment to stepping up fiscal discipline and then made highly publicized yet half-hearted attempts to do so. The IMF has certainly not induced the Russian government to carry out any wide-ranging reform programs, and—as the protests over salary arrears show—it has not sufficed to fill the gaping holes in the federal budget.

Dmitri Simes, the president of the Nixon Center in Washington, argues that if Russia had sought to address its mounting debt problems earlier, it could have weathered the debt crisis through new loans from willing Western banks, using its large government-held reserves of silver and palladium as collateral if necessary. However, such steps were considerably less attractive to Moscow than new IMF and World Bank credits with interest rates of only 4–5 percent, that is, substantially below market rates. But the IMF assistance was not without cost. In contrast to commercial credits, their aid was linked to Moscow's strict adherence to IMF conditions, which, as noted earlier, undermine Russia's prospects for economic growth.<sup>55</sup> Simes also noted that the Russian government cut short talks with potential Western creditors (and investors as well) once the announcement of the emergency IMF aid seemed imminent.

Under the new economic program, Russia's fiscal position was supposed to improve. The federal budget deficit had to be reduced to 5.6 percent of GDP in 1998, from 6.8 percent in 1997. As a result of the measures agreed with the Russian government, the deficit was targeted to fall further to 2.8 percent of GDP in 1999. The Russian government promised many structural reforms of the fiscal system,

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55. "The Russian Crisis: Implications for U.S. Policy," A Presentation by Nixon Center President Dmitri K. Simes. The Nixon Center, Washington, DC, July 22, 1998.

including major measures to improve the tax system, as well as additional reforms agreed in the context of the program supported by the World Bank.

Martin Gilman, the IMF representative in Moscow, commenting on the government's financing plan for July–December 1998, said that the key to its success lay in implementing the policies on which the figures were based, especially tackling long-standing revenue-raising problems. He said, “We find the initial results of what they're trying to do encouraging, but they're going to have to work very hard this month so that these program projections can be realized.”<sup>56</sup>

## Russia's anti-crisis program

Russia's anti-crisis program was unveiled in June 1998 by Prime Minister Kiriyenko. The government announced its wish-list, which included the following intentions:

- Reducing interest rates to 25-30 percent by autumn, then to 20-25 percent, from the current level of 60 percent;
- Adopting new tax and budget legislation;
- Introducing a more uniform income tax scale, with lower rates for all forms of income, including credits and insurance policies;
- Moving towards VAT and excise taxes as means of extracting revenues from sales at time of delivery, introducing a single VAT rate of 20 percent, abolishing the lower rate currently levied on a range of goods, and eliminating exemptions from VAT and from the profit tax;
- Introducing a tax on barter deals;
- Introducing a tax on promissory note issues (0.8 percent of nominal value);

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56. *Reuters*, August, July 6, 1998.

- Giving the regions the right to introduce a 5-10 percent sales tax;
- Tightening state control over the alcohol market and introducing stiffer penalties for illegal output and trade;
- Raising the land tax and payments for unproductive use of land; and
- Raising import tariffs.<sup>57</sup>

The government also wanted to cut the number of employees and agencies funded from the state budget, reduce subsidies from the federal budget, lower transport tariffs for oil and coal, decrease wholesale prices for gas and electricity provided payments were made in cash, cut the hard currency part of crude oil transport tariffs, and reduce import tariffs on equipment and spare parts not produced in Russia. It also promised to move to international accounting standards, strengthen independent auditing and state financial controls, guarantee the rights of minority shareholders, develop the institutional base for private ownership of land and property, reduce salary and pension arrears, introduce faster, streamlined bankruptcy procedures, increase revenues from privatization, achieve a more effective use of state property, develop a mortgage market in Russia, develop a precious metals market in Russia, and improve production-sharing legislation.<sup>58</sup>

The government austerity plan promised to cut 75 billion rubles of budgeted spending in 1998 and slash the government payroll by 200,000 employees. If implemented as planned, the government's drastic fiscal tightening could mean Russia runs a primary surplus of 3 percent of the GDP next year. A host of structural reforms championed by the World Bank, such as regulating the utilities and oil and transport industries more effectively, could stimulate greater competition. The intention was to shift the tax burden from companies to consumers in order to encourage economic growth, and to collect more taxes from individuals, many of whom evade them. The

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57. *Reuters*, June 24, 1998.

58. *Ibid.*



government also promised to conduct fairer and more open privatization sales.

The anti-crisis package provided for spending cuts of 8 percent and a revenue increase of about 4 percent. The government wanted to reduce the public sector work force by 20 percent, cut higher education and reduce the subsidies to agriculture. It also wanted to freeze the indexation for inflation of welfare payments and budget sector salaries. These measures were supposed to save 42 billion rubles (\$6.8 billion). At the same time it proposed to create a state-owned holding company for the alcohol industry. The additional revenues were supposed to bring 20 billion rubles (\$3.2 billion) to the budget.<sup>59</sup>

The Russian government announced its intention to offer to holders of GKO's the opportunity to convert these treasury bills into medium or long-term bonds denominated in US dollars. It was claimed that this initiative would ease the pressures in the GKO market that have arisen during the rolling over of maturing bills and would thus reduce the burden of interest payments on the budget. The strengthening of Russia's economic policies—both fiscal and structural—the large additional financial resources, and the debt conversion scheme were all meant to fundamentally improve the financial situation of the Russian government.

The Ministry of Finance came up with an option for replacing present-day ruble short-term government securities with their dollar equivalents. This measure was expected to preclude Western traders from shying away from ruble-backed securities if they feared the possibility of the ruble's devaluation. The implementation of this strategy meant that the government intended to “dollarize” its entire public debt. In other words, the ruble's reputation was so bad that the Russian Government and the Central Bank, which had talked about a fully convertible ruble only two years ago, proposed to continue to oust it from circulation with the dollar's help.

The Kiriyenko government program to rescue the country from the jaws of financial crisis envisaged a rise in GDP to 788 billion rubles

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59. *Russia Review*, July 17, 1998.

(\$125 billion) in the fourth quarter from 650 billion in the third. The six-month plan, agreed by the finance ministry and IMF, put the budget deficit at 40 billion rubles in the fourth quarter, up from 31 billion in the third.<sup>60</sup>

## Comments on the bailout and the government's package

Skeptics said that the bailout was likely to be not merely ineffectual but even harmful.

For instance, Clifford Gaddy from the Brookings Institution and Barry Ickes from the Pennsylvania State University claimed:

On previous occasions, handing over the money was considered risky because Russia would just take it and then not follow through on reform. Today, ironically, the danger is that Russia might actually do some of the things we ask. The reason for concern is that in the current economic situation in Russia, standard economic reform measures are likely to have effects directly opposite those intended. The outcome could be that today's bailout would become merely the first installment of a continuous stream of infusions needed to keep the Russian economy afloat.<sup>61</sup>

Another critic of the IMF, Jack Kemp, one of the prominent leaders of the Republican Party, believed that "the conditions it seeks would push Russia deeper into crisis."<sup>62</sup>

*Business Week* concluded:

The truth is, the American- and German-backed bailout by the International Monetary Fund was essentially a political act designed to steady a country holding thousands of loose nukes. The luckiest benefactors of this cold war legacy are the foreign and domestic investors in Russia's \$70 billion government treasury-bill

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60. Ibid.

61. *The Los Angeles Times*, July 17, 1998.

62. *New York Times*, 20 July 1998.

market, who sparked the crisis in the first place. These highfliers will now be bailed out of their mistakes: In exchange for their ruble T-bills, foreigners will be offered long-term Eurobonds denominated in hard currency. If Russia had not received the IMF money and been forced to devalue, they would have faced ruin. For these folks, it's no risk and all reward.

Economically, it might make sense to bail these investors out and preserve the government T-bill market if the IMF loan package were to lead to a radical restructuring of the Russian economy. Yet even with the most pro-reform government since 1992, odds are that the Duma would not do what was necessary to turn Russia into a growing market economy. In fact, the austerity that the IMF is insisting on in exchange for its loans will discourage growth. Cutting the budget deficit and collecting more taxes are good ideas in the abstract but will deflate the economy in the short run.<sup>63</sup>

The German newspaper *Stuttgarter Zeitung* commented:

As long as millions disappear on the way from Moscow to the recipient regions, as long as corruption is thriving, and as long as the economy of the country is governed by a minisculely small elite of power-hungry company owners, even the billions from the IMF can only result in a short-term improvement of the situation. The IMF must accept the fact that the money will never be repaid. This is a high price—but it is politically motivated: The West wants to keep Yeltsin in power.<sup>64</sup>

The British magazine *The Economist* admitted that the IMF bail-out would help the foreign speculators more than anybody else:

Many of the Westerners who are crying loudest for others, essentially the Fund, to save the ruble are those same punters who knew they were taking a big risk by playing the up-and-down Russian stock-market in the first place; and a bail-out may well help them more than it helps ordinary Russians. Meanwhile, the Fund,

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63. *Business Week*, July 27, 1998.

64. *Stuttgarter Zeitung*, June 7, 1998.

which is cash-strapped itself, has already provided Russia with generous loans (more than \$9 billion over three years) whose conditions, as things stand, are periodically flouted.<sup>65</sup>

The American magazine *The Nation* came to the following conclusion:

Rarely has the distance between Western perceptions and Russian reality been so great. The insistence of the Yeltsin government and its Western patrons that Russia's crisis is merely financial and can be fixed by monetarist budget cuts and improved tax collection is myopic. The country is in the depths of the most severe economic depression of this century. Unlike Asia, whose crisis followed decades of unprecedented economic growth and massive infrastructure investments, Russia enters its crisis following a decade of infrastructure collapse, capital flight and the kind of mass poverty not seen there since the forties. Industrial production, according to one estimate, has dropped since 1991 by 80 percent, capital investment by nearly 90 percent. The government's 'anti-crisis program' dictated by the IMF and other international lending institutions, will lead to painful consequences like those of the shock therapy policies that already ravaged most citizens in the early nineties. Furthermore, the IMF and other Western loans are saddling future generations with massive debt.<sup>66</sup>

"IMF loans and other government-backed capital transfers do not contribute to new investment so much as they contribute to sustaining old institutions," insisted Lt. Gen. William Odom, a former national-security aide to President Carter who is now with the Hudson Institute. "The only real beneficiaries of the IMF loans will probably be the western investors, who hold about 60 percent of the foreign exposure," Odom said.<sup>67</sup>

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65. *The Economist*, July 11-17, 1998.

66. *The Nation*, August 10-17, 1998.

67. *Philadelphia Inquirer*, July 19, 1998.

According to Jeffrey D. Sachs, director of the Harvard Institute for International Development and a former adviser to the Russian government, the reason for such new loans is to "insure that the earlier loans are repaid and that the ruble keeps its value long enough for speculators to get their money out without large losses."<sup>68</sup>

For a long time, the U.S. House of Representatives balked at an administration request to provide authority for the U.S. Executive Branch to commit \$18 billion to replenish IMF resources drained by last year's rescue deals in Asia. They finally agreed in mid-October 1998, adding some conditions (e.g., that loans should be at market rates). Most of the money for the latest Russia loan came from an emergency lending facility (the GAB) that had not been used for 20 years. Conservatives in Congress say IMF rescue packages encourage "moral hazard," that is, risk-taking by the banks and private investors who would be paid off. Liberals say the austerity measures included in IMF-sponsored reform programs neglect the needs of the poor or ride roughshod over workers' rights.

## The disposition of the IMF bailout

Nevertheless, the Russian Government got 50 percent of the entire loan, or \$6.5 billion, in July 1998. The remaining \$6 billion was promised, as usual, to be disbursed in the form of tranches until the end of the first quarter of 1999.

The bulk of the forthcoming \$12.5-billion loan had to be transferred to the Russian Central Bank's accounts so as to exert psychological pressure on the market and to convince market players that the Central Bank boasts immense reserves. The rest of the loan was targeted to repay previous domestic and foreign loans. Therefore all the money would be spent for so-called financial stabilization.

The problem was that the Central Bank of Russia and the Finance Ministry were not able to retain their domestic resources long enough. Every Wednesday, the Ministry of Finance had to spend approximately \$1 billion to repay GKO debts. The Ministry of

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68. *The Christian Science Monitor*, June 25, 1998.

Finance even had to take money from the federal budget during the last few auctions in a bid to repay the aforesaid GKO debts.

The Central Bank, trying to prevent devaluation of the ruble, continued its policy of spending its reserves to prop up the ruble—an increasingly expensive exercise. While some economists argued that the ruble was worth only 15 or 20 to the dollar, the Central Bank continued to set the exchange rate at about 6.2 to the dollar, thus buying rubles at what these economists said was three times their true value. The number of banks and investors trying to sell rubles far outstripped the number wanting to buy them, so the Central Bank kept the exchange rate steady by buying up the surplus at the official rate.

The Central Bank spent about \$9 billion buying rubles in July and August of 1998. Critics contend that the \$4.8-billion IMF loan was included in this amount and that it quickly vanished into the murky world of Russia's commercial banks.<sup>69</sup> Soon after the IMF loan arrived, the Central Bank's reserves jumped from about \$13 billion to \$18 billion. Less than four weeks later, the reserves had dropped back to about \$13 billion and continued to shrink by an impressive \$800 million to \$1 billion each week. Such extravagance depleted the Central Bank's reserves by mid-August.

The Kiriyenko government backtracked on its promise to limit borrowing and later decided to raise the limit of external borrowing from \$7 billion to \$14 billion.<sup>70</sup> It also acquired about \$3 billion through the sale of additional Eurobonds.<sup>71</sup>

## Devaluation of the ruble

The problem of devaluation of the ruble became the central issue in political and economic developments in the Russian Federation in the summer of 1998. Many argued that the ruble was grossly overvalued. When making the choice between currency devaluation and new loans, the Russian government was choosing between bankrupting

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69. *Los Angeles Times*, September 24, 1998.

70. *Kommersant Daily*, August 7, 1998.

71. *Segodnya*, August 7, 1998.

the banks that feed on the budget or bankrupting industry that feeds the budget. Industry would not have taken notice of devaluation because it does not use the ruble in its transactions—and exporters would have actually gained from it. But there is no way that industry was not going to protest the imposition of new taxes or find new ways to evade them.<sup>72</sup>

Supporters of the devaluation claimed that Western aid was worse than the ruble's devaluation. A sharply depreciated ruble would enable some industries to improve their sectoral performance by cutting back on specific production cost outlays (say, on labor and raw materials). But Western credits have nothing to do with the real sector of the economy. Money was allocated not to facilitate a Russian industrial recovery, but rather to enable purchasers to buy Western-made goods. Those were the so-called tied credits. For its own part, the IMF doesn't care a bit about Russian industry. The IMF aims to get its money (plus interest) back, imposing its own financial stabilization concepts upon any particular "recipient" nation.

But the picture is complicated by the fact that many of the bigger Russian companies have already taken on substantial hard currency borrowings. Gazprom, the giant gas monopoly, has \$9 billion of foreign debts that would prove much more expensive to service in the event of a devaluation.<sup>73</sup> To add to the confusion, many of Russia's banks and oil companies are meshed in sprawling financial-industrial groups. The MENATEP bank and the YUKOS oil company together form part of the ROSPROM empire. Similarly, the UNEXIMBANK lies at the heart of a rival, FIG, which includes Norilsk Nickel and SIDANKO, a big oil producer.<sup>74</sup>

Paradoxically enough, but in the long-term perspective, Western aid has just about the same negative consequences as devaluation does. The allocation of credits depends on specific pre-conditions, which pursue the same goal as devaluation does. For instance, the IMF

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72. *The Moscow Times*, July 28, 1998.

73. *The Financial Times*, June 25, 1998.

74. *Ibid.*, June 25, 1998.

insists that federal treasury should be filled first and foremost at the expense of taxpayers, the nation's population. The Government would be expected to introduce a sales tax, raise VAT (value-added tax) levels and increase income-tax rates. This amounts to insisting that the government conduct a confiscation-style policy in order to obtain all those multi-billion-dollar Western loans. But in case of a devaluation, the Cabinet wouldn't have to repay its debts (plus interest) for another 18 months, so devaluation began to look like a more attractive policy.

### **Duma action on the government program**

On July 17 the Duma and the Federation Council approved some of the measures proposed by the government, including the main outlines of a long-awaited tax code, a cut in taxes on profits, and tighter controls on the production and sale of alcohol. But the Federation Council overwhelmingly passed a resolution that sharply criticized important aspects of the plan. As their resolution said, "The program does not contain measures to revive industrial production, raise investment activity, increase the competitiveness of national industrial output, strengthen currency controls, ensure the ruble's stability or provide social protection for the population."<sup>75</sup>

Under the circumstances, it should be no surprise that the Duma failed to pass the legislation necessary to encourage significant investment even by Russia's own business leaders, who prefer to keep their assets in Switzerland.

Nevertheless the Duma approved enough of a government austerity program to secure the promised \$22.6 billion in loans after it rushed passage of laws intended to boost tax collection and cut the budget deficit. It approved most measures proposed by the government, including a new tax code and a lower corporate tax rate that was intended to encourage companies to pay taxes.<sup>76</sup> The Duma adopted the general part of the tax code, which is key to government efforts to

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75. *Interfax*, July 10, 1998.

76. *Bloomberg*, July 16, 1998.



clarify tax procedures and lower taxes in order to lure new taxpayers out of the shadow economy.

The Duma also adopted a law that will reduce the corporate tax rate to a maximum of 30 percent, down from 35 percent, and distribute two-thirds of the taxes collected to the federal government and one-third to the government of the region where a company is located. Financial-services companies will pay a maximum of 35 percent. In addition, the Duma approved a single tax for small businesses that's designed to increase tax collection by cutting down on tax evasion and simplifying procedures for tax payment. This is good because it significantly lowers taxation on small businesses. It will bring them out of the shadow economy. Under the law, small businesses will be subject to a single 20 percent tax to be paid in advance on estimated sales rather than being subject to the current multitude of taxes.

Among the new taxes is the border payment. Everybody crossing Russia's borders, including the citizens of the Russian Federation, will have to pay 0.8 of their already minimal monthly salaries.<sup>77</sup>

Other laws approved by the Duma would place a new tax on casinos and restructure old tax debts at all levels of government. Earlier, the Duma passed two bills to redistribute income from land taxes in favor of the federal government and to lower profit taxes on companies that sell gas, oil and electricity below cost. It also passed a law regulating the sale by the regions of debt securities. It adopted a draft law on foreign investment in Russia that guarantees protection of foreign investors' rights and interests and details terms for their commercial ventures.

But some critical pieces of the crisis package got stuck in the Duma. The first problem bill provided for a 5 percent sales tax, but it failed by only four votes, while the second aimed to get rid of loopholes in the law on personal income tax.<sup>78</sup> In addition, legislators rejected the 5 percent sales tax in the regions, a government income-tax law that would have lowered the highest tax bracket and targeted income

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77. *Obshaya Gazeta*, July 23-29, 1998.

78. *Financial times*, July 14, 1998.

earned from second jobs, interest payments and gifts, and a measure to increase collection of the value-added tax by collecting it when goods are delivered, not when they're paid for.

The government requested 102 billion rubles of additional revenues. But the Duma approved changes in the tax laws that will provide only an additional 28 billion rubles.<sup>79</sup>

### **World Bank and IMF reactions to the government's program**

"I am delighted the new Russian Government has developed this ambitious program of structural reform," said James D. Wolfensohn, President of the World Bank. "Its implementation will send the clearest signals that Russia's economic management is on track. It should quickly rebuild confidence and create the basis for the emergence in Russia of the prosperity that we all want to see. The World Bank stands ready with substantial financial support to Russia for the implementation of this program and for mitigating the severe social problems which the Russian people currently face."

"The strengthening of Russia's economic policies, both fiscal and structural, the large additional financial resources, and the debt conversion scheme, should fundamentally improve the financial situation of the Russian government,"<sup>80</sup> claimed the Executive Director of the IMF, Michel Camdessus. On July 20 the board of the IMF grudgingly endorsed the multibillion-dollar rescue plan, but it also reduced the size of its first payment to demonstrate its dissatisfaction that Moscow has not delivered all of the economic and structural reforms it promised in exchange for the bailout.<sup>81</sup>

The IMF gave the go-ahead to a package of loans to bolster Russian reserves and support the ruble if the government program were approved, even if some measures were to be implemented by decree. The IMF decided to reduce the first tranche to \$4.4 billion,<sup>82</sup> but

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79. *Kommersant Daily*, July 18, 1998.

80. Reuters, July 13, 1998.

81. *The Globe and Mail*, July 22, 1998.

Moscow had to offset a two-thirds drop in targeted revenues sparked by parliament's refusal to ratify several new taxes.

### **Additional actions by President Yeltsin**

In this situation President Yeltsin decided to close the budget gap by decrees. These decrees are legal under the Constitution, even though the Constitution gives parliament the main say on taxation. On July 18, 1998, Yeltsin signed two decrees to help stabilize the economy. One set up a state holding company for the alcohol industry. The other allowed precious metals producers to export their output directly.

Yeltsin's decrees were even more draconian than the government's proposed legislative program and would raise even more money than the government originally sought (about \$16.2 billion).<sup>83</sup> These measures included orders to double the taxes on apartment houses and quadruple other land taxes, to place a 3 percent duty on imported goods, and to extend the 10 percent VAT to a broad range of products. Kiriyenko also announced a new 3 percent duty on all imports. The move was welcomed by the Communist speaker of the Duma, Gennady Seleznyov, as likely to help domestic producers.

Since the Duma had not adopted all the draft laws in the package, the government tried to put off the implementation of some of the laws the Duma had approved, including new laws reducing taxes on profits and lower excise duties, since on their own they only worsened the budget crisis.

But Article 31 of the Law on the 1998 budget of the Russian Federation signed by President Yeltsin on March 4, 1998, states that, in 1998, the loan agreements on the international loans received by Russia are implemented only if these loans are listed in the program of external borrowings of the Russian Federation and state credits provided by the Russian Federation. The law requires that the government submit

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82. *The New York Times*, July 22, 1998.

83. *The New York Times*, July 22, 1998.

the program for Duma approval within one month from the day the law is signed, i.e., before April 4. I don't know if that was done or not.

According to the 1994 law "On the State External Borrowings of the Russian Federation and the State Credits Provided by the Russian Federation to the Foreign States, Their Legal Entities, and International Organizations" signed into law by President Yeltsin on December 26, 1994, each international loan agreement on a loan above \$100 million requires ratification by the Duma. Lately, the Duma has been approving these programs each year.

The Duma tried to limit this year's external borrowing to a sum below \$10 billion and lower the limit from the 1994 law from \$100 million to \$10 million. "The State Duma will not approve the IMF loans agreed in Moscow that exceed the limit fixed by the law," said Speaker Seleznyov. But the President vetoed the bill. In 1998, the limit set by the law for external borrowings is equal to \$9.1 billion, while the amount discussed in Moscow varied from \$12 to 15 billion.<sup>84</sup> Yet, according to Seleznyov, "Russia will not honor debts incurred in circumvention of the law."

Article 3 of the 1998 budget law allowed the government to change the volumes of internal and external borrowings. However, the government was only permitted to do that under the conditions explicitly listed in that same article: that the cost of servicing the debt and the overall federal debt be lowered, and that earlier loans received by the Russian Federation be repaid with subsequent changes in the program of external borrowings by the government of the Russian Federation. These changes have to be approved by a State Duma resolution.

One of the loopholes in the 1994 law used by the government was that the law did not specifically state that the loan agreements could not be fulfilled until they were ratified. It is my understanding that Article 31 of the law on the 1998 federal budget was designed to plug that gap.

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84. *RIA-Novosti*, June 25, 1998.

The Duma went into summer recess, but Kiriyenko said he hoped it would reconvene for an extraordinary session in August to authorize the extra revenue-raising efforts the IMF wanted to back its credits, credits which were designed to prop up the ruble. The extra revenues would also help pay off wage and pension arrears to millions of Russians, including teachers and doctors. But the rise in payments to the Pension Fund from 1 percent to 3 percent is in clear violation of the decision of the Constitutional Court, which already on February 24, 1998, ruled that increases in these payments can be done only by law, not by government decrees.<sup>85</sup>

As the *Toronto Globe and Mail* commented, Yeltsin "sacrificed the democratic process by autocratically enacting essential parts of the austerity package by decree."<sup>86</sup> And *The New York Times* noted that "governance by decree is undemocratic and ultimately self-defeating."<sup>87</sup>

### **Tax receipts were not forthcoming**

Yeltsin has made countless pledges to improve tax collection, but his government has consistently failed to raise the revenues needed to provide basic services and pay millions of state workers on a timely basis.

The government wanted to bring tax collection in August to 13.5 billion rubles and then raise it every month by 5-7 percent.<sup>88</sup> The State Tax Service was assigned to achieve a level of tax collection of 15 billion rubles per month by November of this year. To achieve this, Boris Fedorov, a wealthy businessman who was appointed to the post of chief tax collector, threatened to fire or demote top officers of state-controlled companies and said the government would initiate bankruptcy proceedings against failing firms. Tax receipts for August were

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85. *Finansovye Izvestiya*, August 4, 1998.

86. *The Globe and Mail*, July 22, 1998.

87. *The New York Times*, July 22, 1998.

88. *Kommersant Daily*, August 12, 1998

expected to total \$2 billion, up marginally from \$1.9 billion in July, which was higher than in June.<sup>89</sup>

The government approved the decision to change the system of financing the State Tax Service and thus approved the associated draft amendments to the law governing the federal budget for the current year. Head of the Service Fedorov explained that the Service was to receive some percentage of its tax collections for its own financing in the event it provided additional tax revenues for the federal budget. It was envisaged that this financing would be established at 2.85 percent of the total tax collection.

However, government efforts to raise tax revenues produced meager results. According to Kiriienko, in June the government collected only 3 percent more than in May, and in July only 5 percent more than in June.<sup>90</sup> Those amounts could hardly reduce the deficit. In July tax revenues reached 12 billion rubles, but the minimal government expenditures could not be reduced below 20 billion rubles.<sup>91</sup>

### **Land reform proposals**

The government also vowed to push ahead with a controversial package of land reforms to secure the World Bank's tranche of a multibillion-dollar international bailout, even though the reforms were vehemently opposed by leftist deputies. The pledge was one of a raft of promises made by the government to obtain a third structural adjustment loan from the bank worth \$1.5 billion, funds which are part of the \$22.6 billion IMF-led rescue package for Russia.

In a letter signed by Kiriienko and Central Bank chairman Sergey Dubinin, the Russian government undertook to approve by August 30 a "federal program for the development of land reform" up to 2001. A presidential decree would guarantee the provisions of the plan by September 30, the official statement said. "The program will guarantee the rights of citizens of Russian Federation to make land deals,

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89. *Associated Press*, August 7, 1998.

90. *Moskovskiy Komsomolets*, August 5, 1998.

91. *Finansovyye Izvestiya*, August 6, 1998.

including the purchase, sale, rent and mortgage of land,” and includes the right to lease land for 49 years, it said. An action plan to implement the program must be approved by October 30, it added.

However, it was unclear what practical effect the initiatives would have, since land reform has been the source of a long-running battle between President Boris Yeltsin and parliament. The bill that provides a legal framework for the private ownership, sale and purchase of agricultural land has been the object of negotiations with various political groups. On June 5, Yeltsin vetoed a version of the draft law passed by both houses of parliament that would have banned agricultural land sales, which are anathema to the leftist-dominated Duma.

The conservative opposition in the Duma has opposed the private ownership of land, claiming it contradicts the millennium-long tradition of communal ownership. The Communist lawmakers and other opponents have also been resisting spending cuts and tax increases, saying that the government should be spending more money, not less, to help struggling Russian citizens and industries.

### **The effects of reform and bailout on the populace**

Even assuming the IMF-imposed program were somehow implemented in law, there remained the question of what effect it would have on Russia's long-suffering population. The projected loan could not defuse current rising social tensions and would fail to stabilize the increasingly shaky Russian political system. With living standards stagnant or falling throughout Russia, unemployment rising, and many workers going unpaid, the prospect of tough government cutbacks was not appealing.

This year the scourge of wage arrears spread in both the public and private sectors. In the past, the Russian government cut spending by the simple and brutal expedient of refusing to pay wages. The trade unions feared the government's new austerity program would take similar steps and its effects would fall heavily on ordinary workers.

Union leaders complained that none of the aid money had been targeted to reduce the estimated 70 billion rubles (almost \$12 billion) in back wages owed to millions of workers. More than half of all

Russian workers experienced disruptions in wages last year, and one-in-four went for three months or more without being paid. Experts say the problem has greatly worsened with this year's financial crisis. Unions claimed that 30 billion rubles (about \$5 billion) of the total debt is owed directly by the government as back wages to public sector workers and as unpaid bills for goods and services provided to the state by companies that consequently cannot afford to pay their employees.

Labor unrest over the issue had been rising for months, and strikes have involved much more radical tactics than any seen in the past, such as railroad blockades, hostage-taking and mass hunger strikes. Protests have so far been sporadic and localized, but that could change if the huge central trade unions become involved under the initiative of the recently established Union of Labor.

Following protests by miners over unpaid wages, the government announced its plan to tighten up a law enforcing separation between labor unions and political parties. "We have to make a strict division between the activities of trade unions and political parties,"<sup>92</sup> Justice Minister Pavel Krashenninnikov said.

According to public opinion polls, those Russians who knew about the IMF were asked to say if, in their opinion, the IMF was good or bad for the country. 35 percent of those polled said Russia did not benefit from the IMF and 31 percent said that it did.<sup>93</sup> 60 percent were sure that the IMF money would be "embezzled."<sup>94</sup> Only 6 percent considered the situation in the country as "normal," 51 percent thought we had a "crisis," and 39 percent believed the situation was "catastrophic." Less than 10 percent of Russians considered the Kiriyenko government "better" than Chernomyrdin's, while about 5 percent thought that Chernomyrdin's government was "better." 52 percent saw "no difference." The level of trust in Yeltsin dropped from 19 percent in December 1997 to 7 percent in June 1998.<sup>95</sup>

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92. *Reuters*, August 12, 1998.

93. *Interfax*, July 23, 1998.

94. *Obshaya Gazeta*, No. 32, August 1998.



## Bailout, devaluation, and the collapse of the government

If nothing else, the promised \$22.6 billion bailout gave the government the chance to procrastinate. The situation did not change after Moscow received the credits from the IMF and the World Bank. The country did not move from the brink. With \$2.08 billion maturing in August, the government said that it would use \$1 billion of the IMF funds to pay off its debts, even though those funds were supposed to be set aside to build up the Central Bank reserves.<sup>96</sup> The most pressing financial question was how to deal with around \$24 billion in short-term debt falling due by the end of the year. The government also had to find roughly the same amount again to pay interest on its debts.

Of course, if confidence were high, the government might have borrowed the needed \$40 billion or so from foreign and domestic investors. Indeed, restoring that confidence was the object of the IMF program.<sup>97</sup> A big gathering of foreign investors on July 30th heard some encouraging words from Kiriyenko and the usual cheerful promises, but even the most optimistic see plenty of bumps in the road ahead.

However, the government's attempt to close the most crucial gap in its finances by raising taxes lost momentum. On August 6 it made the decision to increase the limits for foreign borrowing for 1998 from \$6 billion to \$14 billion. Investors were reluctant to put up new cash. Yields on ruble and dollar debt shot up. Instead of the hoped-for virtuous circle—with lower yields cutting funding costs and in turn producing still lower yields—Russia was now staring at a vicious spiral. Barely two weeks after the first IMF tranche started to fill Russia's treasury, short-term interest rates were again hovering around 80 percent, later rising to 150 percent, and by August 15 rising to 300 percent a year. Dollar-denominated bonds were at all-time lows and the equity market had fallen back to its pre-rescue level.

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95. *Nezavisimaya Gazeta*, July 18, 1998.

96. *The Moscow Times*, August 13, 1998.

97. *Financial Times*, July 30, 1998.

In his letter to the *Financial Times*, George Soros suggested that the action needed to resolve the banking crisis was diametrically opposed to the action the government had agreed upon with the IMF to solve its budget crisis. "The IMF program imposes tight monetary and fiscal policy; the banking crisis involves the injection of liquidity," he wrote.<sup>98</sup> Soros claimed the only way out of this dilemma was to introduce a currency board—backed by \$50 billion in reserves—after a 15 to 25 percent devaluation of the ruble. He argued that with Russia having \$17 billion of reserves and the International Monetary Fund and World Bank agreeing to provide a further \$17 billion of assistance, the Group of Seven leading industrial nations should provide a further \$15 billion to shore up confidence in the new regime, adding that any delay would be disastrous.

But a currency board would effectively hand over Russia's monetary policy to the foreign central bank administering the currency to which the ruble was tied. Such currency boards, which fix the local currency to a hard currency and ensure that the domestic money supply expands or contracts in line with hard currency reserves, have brought financial stability to countries as diverse as Argentina, Estonia, and Singapore. Moreover, selling that idea to the Russian Parliament would probably be impossible.

President Yeltsin pledged on TV that the ruble would be not devaluated, but two days later, on August 17, 1998, the Kiriyenko government announced that it would let the value of the ruble fall about 50 percent—from about 6.3 to 9.5 per U.S. dollar. It also announced that it was halting payment on the GKO's and imposing a 90-day moratorium on payment of ruble-denominated international debt. The government and the Central Bank also said they would pull their resources out of leading Russian banks in order to limit the damage to the banking sector, which was over-dependent on ruble assets.

The IMF funds were used to restructure the government debt by exchanging ruble-denominated GKO's for debt denominated in foreign currency. There was a short-term saving in debt-service costs, but in exchange there was an escalation in the potential cost of any future

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98. *The Financial Times*, August 13, 1998.

exchange rate adjustment. The larger the foreign debt, the bigger the increment of debt service costs associated with any devaluation. Therefore, when the bailout failed and the ruble was devalued, Russia found itself in a much worse shape than if the ruble had been devalued in the spring of 1998 or earlier.

After the value of Russia's currency dissolved, the economy was in a shambles. Many of Russia's banks became instantly insolvent. Inflation jumped dramatically. The State Statistics Committee reported output in August was 11.5 percent lower than a year earlier. Inflation reached 43.3 percent in the first two weeks of September.<sup>99</sup>

The Finance Ministry said tax revenues also had plummeted during the crisis. The government has been collecting only one quarter of tax revenues than they had been collecting before the collapse. The Central Bank told the cabinet that December-to-December inflation could reach 240–290 percent if the ruble fell to around 20 to the dollar, and closer to 450 percent if it fell to 30. According to the Central Bank, Russia's economy may plunge 5 to 6 percent in 1998, adding to the seven-year-long depression.<sup>100</sup>

The government quickly lost any control of the economic and financial situation. The Russian economy melted down. In light of these developments, the value of the ruble collapsed, with catastrophic consequences. The involuntary devaluation devastated the remaining confidence in the currency, inducing panicky individuals and businesses in Russia to sell rubles for dollars, further reducing the value of rubles. With popular reluctance to hold on to a depreciating currency, spending rapidly increased and inflation surged. With large hard currency debts, Russian banks were overexposed, so that the devaluation brought most big banks to the verge of bankruptcy.

On August 24 Yeltsin fired Kiriyenko and nominated his predecessor Victor Chernomyrdin as his replacement. But the Duma twice rejected the nomination of the “new old” Prime Minister. The country found itself in the midst of a grave political crisis as the president

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99. *The Christian Science Monitor*, September 28, 1998.

100. *The Washington Post*, September 25, 1998.

threatened to dissolve the parliament and the Duma initiated the constitutional procedure to impeach the president.

As the third and final vote on Chernomyrdin neared, Yeltsin nominated Foreign Minister Evgeniy Primakov instead as the new Russian Prime Minister, and he was overwhelmingly approved by the Duma. A Public Opinion Foundation poll of 1500 Russians across the country found that 67 percent approved of the choice of Primakov. Only 13 percent disapproved.<sup>101</sup> Now it's Primakov's government that has to deal with the mess left by his predecessors.

The new government, which includes some Communists and representatives of the centrist political parties, has to prevent further economic disaster, provide enough food to the population this winter, and level the mountain of debt. "We understand how important fiscal discipline is and the government will conduct a tough policy against individual, corporate and regional tax dodgers," Primakov said in televised comments. "But administrative measures are not enough. The government intends to lower the tax burden on both Russian and foreign producers and to create conditions and guarantees for investors in the real economy."<sup>102</sup> Later Primakov promised to pay the delayed salaries, to restructure the banking system, to cancel the enormous tax debt of the enterprises, and to meet Russia's obligations to investors.<sup>103</sup>

Victor Gerashchenko, the new head of the Central Bank, outlined his proposals for rescuing the Russian financial system. These called for printing at least 40-50 billion rubles (\$2.5-\$3.1 billion) by the end of 1998 to help meet urgent budget requirements in the absence of external financing. Gerashchenko also wanted to control use of central bank credits to limit the impact of printing more money on inflation and the exchange rate.<sup>104</sup>

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101. *Reuters*, September 22, 1998.

102. *Reuters*, September 24, 1998.

103. *The Washington Post*, October 7, 1998.

104. *Reuters*, September 30, 1998.

However, the IMF, which has lent Russia almost \$19 billion over the past four years, has already told the Russian government that it does not believe in the concept of a “controlled emission” of money. It has warned Russia that high inflation could follow.<sup>105</sup>

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105. *The Financial Times*, September 30, 1998.

## The prospects for Russia's recovery

Russia is in a terrible economic shape. Output in Russia has fallen 50 percent in the 1990s. Capital investment is down 90 percent. Meat and dairy livestock herds have shrunk 75 percent. Some 8.35 million people, or 11.5 percent of the work force, are jobless.<sup>106</sup>

It's clear that the Western loans are only a temporary fix for Russia's fundamental fiscal and economic problems. To avoid lurching from one crisis to the next, the government must improve tax collection, cut spending, find ways to pay months of back wages, and eliminate or reduce the widespread use of barter in the economy.

One wonders, then, what will happen when it comes time for Russia, whose financial problems remain massive and unresolved, to pay the foreign creditors back. Not only must the Russian government find the funds to pay the back wages of workers and the bills of unpaid contractors, it must also find new money to cover the debt service on Russia's new loans. If debt service amounted to 36 percent of the federal government's budget expenditures in 1998, the \$23 billion increase in new loans, which is equal to 5 percent of GDP, will push up debt service to as much as 45 to 50 percent.<sup>107</sup> Russia will probably need another long-term restructuring of its foreign debts before the end of 1998. But the new delay in repayment of the sovereign debt is hardly possible without difficult compromises with foreign creditors.

The Russian Federation must proceed with economic reform and show the world that it can do so successfully. It is clear that the Russian government has no easy options. It remains highly vulnerable to global events and market moods beyond its control. Yet events across the fall of 1998 could prove critical in determining the stability of the

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106. *The Christian Science Monitor*, September 28, 1998.

107. *Moscow News*, July 21, 1998.

Russian economy and Russia's political system for years to come. It has become something of a cliché to argue that Russia is forever at a turning point. But this time it may be true. Russia's financial future still looks dreadfully precarious. The worry is that the country will either default or resort to printing money. In either case, the ruble would plummet and the economic reforms of recent years would be thrown out of the window. One cannot exclude that the production drop may have turned into a period of stagnation, which may very well be followed by another decline. According to some estimates, Russia at best cannot begin to recover economically before 2000.

Any hope of economic growth must be put far off into the future. An immediate answer to the current crisis must involve a willingness of foreign banks to be flexible regarding their loans to Russian banks that are suffering from a liquidity squeeze but are otherwise solvent. A forced rescheduling for domestic investors was inevitable.

Faced with this crisis, the Russian leadership has to make strategic choices about the country's economic development during the next 5 to 10 years. But if one looks carefully at the real Russia today, there is no reason to believe that the Yeltsin government is any more democratic, any more pro-Western, or any less corrupt than the likely alternatives. Almost all of Russia's major opposition parties are committed at least partially to political and economic reform and to good relations with the West. Yet, to the extent that anti-Western and specifically anti-U.S. sentiment has grown in recent years, this sentiment has been fueled significantly by resentment of the West, and the Yeltsin government has used this resentment as a convenient alibi for its own failures.

Moscow is paying back old debts with one hand while accumulating more and more loans with the other. The Russian Federation has turned into a sort of "financial drug addict," becoming more and more dependent on foreign credits. Where will it leave the country by the next decade, when the national economy is expected to start gaining momentum?

Only in the event of rapid economic growth, and above all the rapid growth of hard-currency exports, is it even conceivable that Russia

will be able to cope with the heavy debt repayments facing it in the first decade of the twenty-first century.

## Steps that Russia should take

If the Russian Federation is to become a credible member of the global market, it needs economic and financial institutions strong and transparent enough to retain market confidence and resilient enough to weather tight budgetary policies. The current crises can be perceived as an opportunity for Moscow to conduct overdue reforms, specifically to tackle structural weaknesses, to correct the inefficiency of fiscal policy, to reorganize the banking sector, and to get rid of the pervasive "crony" capitalism.

A number of serious problems will have to be solved simultaneously during the next few years if the confidence of Russian citizens is to be restored in their own government.

- First, it is necessary to end the mythological conflict between the state and the market. The modern market is impossible without the state taking an active role in regulation of the economic sphere. If our state is unable to learn to master modern tax and monetary methods of regulation of economic processes, market reform in Russia will not be a success.
- Second, the federal budget should become the main instrument of state economic policy. It is necessary to set precise priorities in budgetary policy. It is time to put an end to arbitrariness in the budgetary sphere and to create a normal mechanism of cooperation between the legislative and executive powers when developing and implementing the state budget.

In addition, the following steps must be taken:

1. First of all, it is necessary to *prevent further pauperization of most of the population, increase solvent consumer demand, and ensure political support to deepening economic reform*. The destruction of the social, economic, and political stability of the society due to excessive property differentiation, growth of unemployment, and



poverty should not be allowed. Stabilization of the social sphere requires the maintenance of sufficient budgetary financing of the social safety net and the health and education systems.

2. There is a need to *stimulate real economic activities* in many areas. Interest rates should be cut significantly to allow the barter sector of the Russian economy to monetize. That will help to restore the taxable base for government revenues and prepare the ground for substantial economic growth.
3. Russia's revival is impossible without *broad and huge investments*, including foreign investments. Return of illegally exported capital could be an important source of investments. This will become possible only if a favorable investment climate is created in the country, which requires a significant improvement in legislation and fiscal policy. That also means that Moscow must avoid further defaults on its foreign debts and start repaying them in the next decade.
4. Today's taxation system undermines the government budget, makes production unprofitable and only promotes criminalization of the economy. *Fiscal reform* by reduction of the enormous tax burden on the production sectors has become pressing if investments and development of production capabilities are to be stimulated in key spheres of the economy.
5. *Scientific and technological policy* should be directed at preventing a complete breakdown of fundamental sciences in Russia and ensure creation of an efficient mechanism for the transfer of scientific achievements to the market sphere. Preservation and development of Russia's R&D potential should be aimed at ensuring Russia's independence in basic spheres of scientific and technical progress in the 21st century.
6. *Industrial policy* should protect the interests of domestic producers and promote the modernization of Russian manufacturing industry to make it competitive in the global markets, while avoiding extremes of protectionism. Russia's integration into the world economy can be achieved if the raw material potential of the country becomes a basis for the development of highly technological production, primarily machine-building.

Especially important is the improvement of Russian communications and transportation systems.

7. The Russian Federation *should not allow preservation of critical dependence of the economy upon the import of essential types of products whose production can otherwise be provided by local capabilities*. The consumer market in Russia should not be abandoned to foreign products.
8. *Agricultural production should be stimulated* through the creation of a modern market infrastructure. Russia has to be self-sufficient in supplies of food and other agricultural products. This will require substantial investments.
9. Resolution of the issues of *military reform* and the *conversion of the defense industry* should not be delayed indefinitely. Choice of the right priorities in the development of the force structure will allow the government to reduce the defense burden on the economy. Without a well thought-through reduction and reorganization of the armed forces, economic reform will not be a success.
10. It is time to finally decide on *Russia's policy towards the CIS*. Access to markets and resources of the former Soviet republics should become a key factor in Russia's economic development during the next few years. Instead of subsidizing the former Soviet republics, the Russian Federation should initiate policies to stimulate economic growth within the CIS or in a smaller set of key post-Soviet states that could constitute a more efficient "common market." Successful economic integration of Russia, Ukraine, Belarus and Kazakhstan will be possible only if Moscow gets rid of the "big brother" syndrome and acknowledges the equality of the other partners.
11. *A balanced foreign economic strategy* should be developed and implemented that would, on the one hand, ensure satisfaction of the needs of the domestic market and on the other, protect vital spheres of the Russian economy against unfair competition.

The above tasks should be carried out within the next few years before Russia's economic infrastructure, an infrastructure created by several generations, has been completely destroyed. It also has to be resolved before the "possibility window" opened by the suspension of payment of Soviet debts till 2002 has closed. This means that the Russian Federation should enter the 21st century with a clear strategy of economic development that will not only allow it to complete restructuring, but also to maintain high rates (5-10 percent per year) of economic development. In this case, Russia will be able to become one of the most developed states and leaders of world development again during the lifetime of the next generation.

Without help, Russia faces near-certain economic collapse, which will set back its economy and perhaps its democracy for years. With help, the Russian Federation has a chance, a window of opportunity, in which to revive its economy. That window may yet slam shut, but standing idly on the sidelines is not a good option for the world's rich countries.